Capital Markets Group

Points to Ponder

December 16, 2021

The First Tee...

Not a Happy New Year…financial markets have been focused on tightening monetary policy, but expiration of pandemic fiscal stimulus could have largest economic impact:

- Government programs supporting businesses and households have been key to recovery:
  - Global fiscal stimulus cuts are projected to reduce GDP by 2.5 percentage points next year…this reduction is five-times larger than the government funding reduction seen as the world economies recovered after the financial crisis:
    - The spending reduction will probably slow economic growth but could also aid in easing inflation price pressures.
- Here is a snapshot of current fiscal spending reductions in the major world economies:
  - **United States**..GDP growth is forecast to slow to a 1.5% rate by the end of next year, down from +5.7% this year:
    - The Brookings Institute asserts the impact from federal and state & local-government taxes and spending turned negative during the second quarter and will remain that way into 2023 (which could also impact next year's mid-term elections).
    - Despite the negative outlook, there are some factors that could ease some of the economic deceleration:
      - President's Biden proposal for $1.75 trillion in social infrastructure spending (Build Back Better)…if passed, the bill would have a limited impact in 2022 but will provide stimulus over multiple years (the tax increase to fund the bill could be economy negative).
      - State & local governments have been slow to spend some of the federal pandemic funds, leaving money for future needs.
      - Households boosted savings during the pandemic by almost $2 trillion, creating a cushion to some of the future fiscal drag.
  - **European Union**…Germany is pushing for austerity, but many countries in the EU are resisting against the amount and pace of stimulus withdrawal (many European nations saw an extended economic slump after the Great Recession due to aggressive austerity programs):
    - Eight EU nations, led by Austria, have written a letter supporting cutting debt levels in an attempt at fiscal integrity:
      - France, is pushing for pro-growth polices across Europe, boosting spending plans in its budget next year (increasing its budget deficit).
    - Any action by the EU will not be immediate as debt and deficit rules have been suspended through 2022:
      - The EU's Stability and Growth Pact has been controversial as it limits governments' room to make budget changes.
  - **United Kingdom**…England has placed a sharp tax increase on businesses and individuals to pay for healthcare:
    - Rishi Sunak (Chancellor of the Exchequer) is working to eliminate government borrowing for day-to-day spending, with a longer goal of reducing Britain's national debt by 2025…Sunak has stated it is "immoral" for the government to rack-up more debt.
  - **China**…the Chinese government has been surprisingly restrained in utilizing fiscal spending to boost its economy:
    - The communist government has typically refrained from running a deficit, but is targeting a 3.2% shortfall this year:
      - Spending is being focused on improving housing, public services, and pensions (the country is dealing with a real-estate crisis).
  - **Japan**…Japan has a new prime minister; another stimulus package is expected to cover campaign promises:
    - Japan is the most indebted to GDP nation in the world…the new package is forecast to cost an additional 5% of GDP.
- **Pandemic Pause**…a move to fiscal discipline may not be as severe as feared (especially if there is more COVID spikes):
  - Budgets are not set in stone…if the pandemic persists, governments will be reticent to restrict economies too much with spending cuts.

Happy Holiday…U.S. pandemic fiscal policies have boosted earnings (corporate and individual):

- Government support resulted in household incomes rising the past year and a half:
  - Income gains during a crisis is unprecedented…the increase allowed consumers to remain active buyers of goods and services:
    - **Total worker compensation was up 12% during the 3rd quarter**, versus the same period in 2020 (many workers saw raises):
      - Hourly earnings broadly kept pace with the rising cost of living…some low-pay industries outpaced inflation (such as leisure & hospitality).
    - Households have also rebuilt nest-eggs though a large boost in the savings rate since the pandemic started:
      - The savings rate has averaged 15.4% since March 2020…more than double the 7.5% average seen the twelve months prior to the pandemic.
  - Businesses have seen profit margins rise during the past two quarters to the highest level since 1950:
    - Despite rising costs for labor and materials, corporations saw profits increase an average of 37% versus a year ago:
      - The earnings gains have been key drivers to the stock market's phenomenal performance during the pandemic:
        - **U.S. index gains since their pandemic lows in March 2020…Dow: 93%, S&P 500: 110%, NASDAQ: 124%, Russell 2000: 122%:**
          - *You can't get much merrier than that from an investor's viewpoint!*

At the turn...

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The Back Nine…

The Big Bang Theory…the London Interbank Offered Rate (LIBOR) will meet its demise **at the end of the year, known as the big bang…after a half-century being the benchmark for rates on financial products:**

- Over $370 trillion worth of financial products are tied to LIBOR, including equipment leases, auto and student loans, bank deposits and derivatives (traded in five different currencies):
  - LIBOR was designed to reflect the rates banks are willing to lend money to each other.
  - Interest rate swaps (the trading of a fixed-interest rate for a floating one or visa-versa) are one of the largest financial tools utilizing LIBOR…utilized by banks, companies, and investors to hedge risks or to speculate:
    - U.S. dollar transactions tied to LIBOR comprise the largest amount based on the benchmark, at over $200 trillion.
- LIBOR's end is due to evolving markets and being discredited during the financial crisis:
  - Regulators became aware that in 2008 lenders had manipulated LIBOR rates to their own benefit:
    - Many large global banks paid billions of dollars in fines…in 2017, the Bank of England decided LIBOR would be phased-out:
      - The U.S. LIBOR transition is being overseen by the Federal Reserve backed Alternative Reference Rates Committee.
- **Not a perfect mouse trap**…the Fed's Secured Overnight Financing Rate (SOFR) has emerged as the new benchmark to replace LIBOR (rate calculated on overnight repurchase agreements for loans collateralize with U.S. Treasury issues):
  - SOFR levels are determined based on median daily volume trading activity of $1 trillion:
    - A concern with SOFR is it primarily follows what the Fed is doing with interest rates…not always reflecting market conditions:
      - During a crisis, the Fed is typically lowering rates to stimulate the economy, but LIBOR rates are historically rising during these periods as a reflection of increased credit risk among banks…allowing investors/creditors to hedge their positions:
        - The latest example of this phenomenon occurred at the start of the pandemic…the Fed was pushing its benchmark Fed Funds target to 0%, while 3-month LIBOR spiked from .74% on March 12, 2020 to 1.45% on March 30. 2020 (it took a month before LIBOR fell back to .74%).
    - Another issue with SOFR is it reflects a one-day rate level and not term…removing ability to exhibit expectations of rate changes
      - In the U.S. an alternative benchmark is gaining popularity, published by the American Financial Exchange (Ameribor), it does incorporate credit risks and offers longer-term rates…in Europe, there is the ICE Benchmark Administration's Bank Yield Index:
        - In July, officials endorsed a series of forward-looking term benchmarks tied to SOFR based on futures trading (easing some of the push-back).
- **The Grandfather Clause**…LIBOR based contracts extending past the end of the year are problematic:
  - Known as "legacy" contracts, updating these agreements has proved challenging…primarily due to fears that mass litigation could ensue as lenders and borrowers fail to agree on a new rate following LIBOR's expiration:
    - To relieve some of the pressure from legacy contracts, regulators have extended the deadline for dealing with these agreements until June 30, 2023…by which time the contracts will be expired *(much to the chagrin of the attorneys)*.
- **Protecting the little guy**…regulators will scrutinize lenders and asset-mangers closely if consumers are forced to pay higher interest rates due to the LIBOR transition…with increased risk of fines, litigation, and reputational risk.

19th Hole...

Christmas time is here…Oh, that we could always see such spirit through the year!

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